EXECUTIVE SECRETARIAT
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Executive Secretary

8/16/84
Date

3637 (10-81)

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

August 15, 1984

~~UNCLASSIFIED~~
(with ~~Secret~~ Attachment)

MEMORANDUM FOR THE VICE PRESIDENT
THE SECRETARY OF STATE
THE SECRETARY OF DEFENSE
THE SECRETARY OF AGRICULTURE
THE SECRETARY OF COMMERCE
THE DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS
DIRECTOR OF CENTRAL INTELLIGENCE
UNITED STATES TRADE REPRESENTATIVE
ASSISTANT TO THE PRESIDENT FOR NATIONAL SECURITY AFFAIRS
ASSISTANT TO THE PRESIDENT FOR POLICY DEVELOPMENT
CHAIRMAN, FEDERAL RESERVE BOARD
PRESIDENT, EXPORT-IMPORT BANK
ADMINISTRATOR, AGENCY FOR INTERNATIONAL DEVELOPMENT

Subject: IG-IEP on International Debt

Attached are papers for discussion at the meeting of the IG-IEP on International Debt on Friday, August 17. The material on Argentina must be closely held.

Christopher Hicks
Executive Secretary and Executive
Assistant to the Secretary

~~UNCLASSIFIED~~
~~(with Secret Attachment)~~

THE INTERNATIONAL DEBT STRATEGY

Introduction

Our approach to the international debt problem is of necessity a pragmatic one in which countries are treated on a case by case basis. No comprehensive solution or formula could be applied indiscriminantly to countries which are very different with respect to their stages of development, their adaption to global economic trends and their respective relationships to the international private and public credit system. Debtors also vary by need, capacity for adjustment, and potential for sustainable long-term growth. Creditors operate under varying constraints, with differing obligations and limits to their ability to adapt to debtor problems and demands. This diversity is the principal obstacle to a comprehensive solution to the debt problem.

For this reason, our debt strategy is a set of related conditions, which, if fulfilled over the medium-term, can lead to a basic improvement in the creditworthiness of many of the heavily indebted countries. Success would be defined by those countries developing an improved capacity to service their debt while allowing imports to grow sufficiently to support sound economic growth.

The strategy was first enunciated in the fall of 1982 in the wake of the Mexican debt crisis. It was endorsed by the seven Heads of State at the Williamsburg Summit in 1983, and has wide support throughout the international financial community. It was reaffirmed at the London Summit in early June.

- The Five-Point Strategy

In its original formulation, our international debt strategy consisted of five elements:

The first, and indeed central, element of the strategy is that debtor countries in financial difficulty adopt comprehensive, credible and effective programs for strengthening their balance of payments and stabilizing their economies.

The second element is that the industrial countries follow policies leading to sustainable, non-inflationary economic growth and keep their markets open to exports from developing countries.

The third element in our strategy has been a strengthening of the IMF. Its resources have been increased and it plays a major supporting role in helping debtor countries to formulate needed adjustment programs so that creditors are encouraged to provide financial support.

The fourth element is continued commercial bank lending for countries making determined adjustment efforts including, in most cases, the provision of net new finance.

The fifth element is the readiness of creditor governments to provide bridge financing on a selective basis when appropriate. This financing generally fills the gap between the time when a program has been worked out with the IMF but before its resources and those of the commercial banks are disbursed.

At the London Summit in early June the debt situation was reviewed within the framework of our agreed debt strategy. The Summit Communique on this issue:

a) Reaffirmed the central role of the IMF, its cooperative relation with the World Bank and called for the strengthening of the latter's function in the area of medium- and long-term development,

b) Encouraged private banks to make more extended multi-year rescheduling of their credits and expressed the willingness of governments to consider doing the same for countries who are adjusting well, and

c) Emphasized the potential importance of direct investment.

- Alternative Strategies

Numerous proposals have been presented during the past two years "to do something" about the debt crisis. Many of the more dramatic ones are quite comprehensive in scope and include sweeping transfers of private credits to creditor governments, substantial relaxation of IMF-supported adjustment programs, and increases of official credits, both for the MDBs and bilateral programs.

These proposals fail to take into account differences in the development environment and debtor/creditor relationships. Many are politically unrealistic in that they assume a public intrusion into the market place as well as a commitment of budgetary resources that neither the Executive Branch nor the Congress believe is desirable.

Resolving the debt problem will take both time and patience. All the players -- debtor country governments, commercial banks, creditor governments and international institutions -- need time to assess their experience and their ability to innovate. Prolonged negotiations, conducted patiently and with restraint, will be needed if the principal actors are to deepen their understanding of the dimensions of their problems and the nature of the solutions that may realistically be applied.

- The Outlook

Rapid and sustained OECD recovery is critical to the process and access to industrial country markets must be maintained in the face of increasing protectionist pressures. The U.S. expansion has already had a dramatic effect on Latin American sales to us and in general, we can expect widespread LDC export gains this year and next. On the other hand, interest rates have risen and although the extent and duration of these increases is uncertain, it is likely that average interest rates paid by LDC borrowers will be higher this year and next than in 1983. Nevertheless, compared to the crisis period of 1980-82, world economic and debtor country performance is much better. This suggests that the general principles of our debt strategy remain realistic.

We are now entering another phase in which various nations are at different distances along the road to adjustment. In Latin America, for example, Mexico is the most advanced and Argentina and Bolivia the furthest back. The London Summit Communique recognized this new reality by endorsing the concept of multiyear rescheduling for countries such as Mexico that have made the best adjustment, look as if they will continue to follow sensible policies but continue to have very heavy debt service obligations. We are in the process of working out with other governments how this approach might be applied in the Paris Club for government and guaranteed private credits and the relationship of government rescheduling to private bank rescheduling.

Another important next step is increasing the awareness that, as countries strive to cope with their debt burdens, they need to re-examine their policies towards direct foreign investment. Such investments provide not only needed capital and technology, but also stabilize capital flows and improve the management of external debt. The major debtors need to become less dependent on credit.

In this evolving situation we must be alert to new problems and seek to adapt the application of our basic strategy to new problems as they arise. But whatever changes that prove to be necessary should be made in a manner which strenghtens the international capital market.

U.S. Treasury/OASIA
8-14-84

ARGENTINA: OPTIONS AND STRATEGY FOR THE NEXT SIX MONTHS

ISSUE

During the third and fourth quarters of 1984, Argentina confronts a very heavy repayments schedule with anticipated inflows from official and private sources clearly insufficient to offset scheduled payments. The financing gap amounts to more than $3 billion during the second half of 1984. The GOA will thus be forced to seek extensions on repayments on a variety of credits which fall due in the third quarter and also incur continued arrears on interest payments. Argentina's creditor banks, however, appear incresingly less willing to grant extensions without agreement on a Letter of Intent.

The Argentine bank advisory group's rejection of an extension on the repayment of $125 million could eventually lead the GOA to adopt a confrontational course towards both the IMF and banks. Minister of Economy Grinspun was angered by the rejection and initially threatened to disband the bank advisory committee, suspend talks with the IMF and consider other responses. He subsequently relented, after a full cabinet meeting, and the GOA appears to have accepted the advisory group decision. Nevertheless, the initial reaction of Minister Grinspun points up the significant risk that the GOA might adopt more confrontational tactics and underscores the volatility of the Argentine negotiating position.

There is an strong likelihood that Argentina will not reach an agreement with the IMF before the fourth quarter. This could lead to a serious political and economic deterioration that threatens that nation's democratic experiment. While Argentina's ability to defy the IMF and the world banking system is strictly limited, there is a need for a phased coordinated strategy to minimize the potential damage to our international debt strategy and the financial system. An additional crucial question is how far we are willing to go in support of Argentine democracy. An optimal strategy would insure the attainment of the following objectives:

(1) Bring continued pressure to bear on the GOA to undertake needed economic adjustment and maintain a responsible posture vis a vis its financial obligations.

(2) Minimize Argentina's deleterious influence on other LDC debtors and discourage other challenges to orderly adjustment.

(3) Reinforce and protect existing mechanisms (e.g., the present international debt strategy) for dealing with the debt problem while rewarding successful adjustment as appropriate (e.g. multi-year reschedulings) and maintaining the traditional roles for the IMF, banks, and creditor governments.

(4) Avoid further politicization of the debt issue into a North-South confrontation.

(5) Support and strengthen democratic institutions in Argentina and elsewhere in Latin America.

OPTIONS

Based on the discussion at the June 27 SIG-IEP meeting, the following options appear open to the United States. It is important to note that the options are not mutually exclusive.

OPTION #1: The United States consults with the G-5 Debt Deputies to determine the feasibility of a joint action plan to increase the pressure on Argentina.

ADVANTAGES

- Provides for a coordinated response to Argentina.
- Brings pressure to bear on the GOA to reach an agreement with the IMF and banks.
- Multilateralizes the issue, making arguments more compelling to the GOA.
- Entails a reduced risk of an open confrontation between the United States and Argentina that would become quickly politicized within Argentina and other LDCs.

DISADVANTAGES

- This would probably be largely symbolic in the first instance, until it leads us to specific, concerted action against Argentina.
- Could ultimately provoke a North-South confrontation.
- Could begin a process which might get out of our control given some others' attitudes toward Argentina.

OPTION #2: The United States, through consultations with other (primarily Latin American) countries, expresses serious concern about the financial implications for Argentina and the adverse impact on financial markets for other LDCs of GOA persistence in a course of intransigence and increasing confrontation.

ADVANTAGES

- Makes it clear that the GOA could not proceed on its present course for more than another six months without serious deterioration.
- Minimizes possibility that other countries conclude that Argentina is "getting away" with no adjustment program while defying the banks and the Fund.

- o Reduces the danger that other LDCs would blame the United States for further Argentine economic and political deterioration.

DISADVANTAGES

- o Would probably be viewed as confrontational by Argentina.
- o Would put other LDCs in the middle, making it politically difficult for them to pressure Argentina for fear of being accused of being a lackey of the U.S.
- o Could be seen as a prelude to harsher action.

OPTION #3: The United States maintains its present stance of helpful but detached concern for Argentina and holds out the prospect of direct U.S. support if Argentina undertakes needed adjustment. This is based on the hope that, by end-September, Argentina reaches agreement with the Fund and begins to put together the required critical mass of bank financing. In the interim, the USG assesses precisely how far it is willing to go to rescue Argentina if the situation further deteriorates.

ADVANTAGES

- o Supports the democratic transition taking place in Argentina.
- o Supports the view that the USG does not wish to see Argentina economically devastated and fall to a militant rightist or leftist dictatorship.
- o Keeps dialogue open.
- o Discourages politicization into a North-South confrontation.
- o Avoids precipitous actions that could prove counterproductive and which, in the final analysis, we would not be willing to see carried to a logical conclusion.
- o Leaves substantial scope for flexibility in applying pressure on the GOA and other LDCs.

DISADVANTAGES

- o U.S. could be perceived as weak, indecisive and ineffective in the face of serious challenges if this option is pursued without other supporting actions.
- o Could be ineffective in pressing Argentina to take necessary adjustment measures.

RECOMMENDED STRATEGY

It is recommended that the United States adopt a phased, incremental strategy that brings pressure to bear on Argentina to adjust, alerts other LDCs not to follow suit, but preserves a maximum amount of flexibility and sensitivity to Argentina's political situation. We recommend that this strategy be implemented on a step-by-step basis as follows:

1. The United States does nothing to encourage or discourage bank lending -- maintaining its present stance of helpful but detached concern for Argentina.

2. If, by early September, there is no agreed Letter of Intent, the United States consults with the G-5 Debt Deputies and develops a joint action plan focused on separate, concurrent, and private demarches by the creditor governments to the GOA expressing concerns over their failure to adjust and reach agreement with the IMF.

3. If adequate progress has not occurred by mid-September, the G-5 demarches to the GOA are followed by Treasury consultations with the major, more moderate, Latin American LDC debtors to encourage them to exert their influence to moderate Argentina's position, and to discourage other LDC debtors from seeking a more confrontational approach to their debt problems. These demarches would be completed prior to the IMF/IBRD Annual Meeting (September 22-27).

4. If the GOA is still intransigent at the beginning of the fourth quarter and is unresponsive to creditor and LDC government overtures, creditor governments would consider common financial pressures, such as a curtailment of official export credits.

5. If Argentina moves to an increasingly confrontational mode and other LDCs become more militant in their support of the GOA, the United States -- after appropriate consultations with both creditor and key LDC countries -- adopts a coordinated effort to isolate the GOA while avoiding direct official statements against the regime. ~~The effort would focus on the financial~~ implications for both Argentina and other LDCs' acccess to needed finance of Argentine persistence in a course of instransigence or confrontation.

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ASSESSMENT OF RECOMMENDED STRATEGY

ADVANTAGES

- Provides for a gradual escalation of pressure that is limited to matching but not overreacting to a continued deterioration of the Argentine situation.

- Shows consistent moderation, minimizing the risk of polarization or alienation of other LDC debtors.

- The reactive (rather than preemptive) nature of U.S. and other creditor responses shows continuing support for Argentine democracy.

- Emphasizes distinctions between Argentina and more moderate major LDC debtors and serves to isolate Argentina if it adopts an increasingly confrontational stance.

- Effectively supports the present international debt strategy.

DISADVANTAGES

- At first, the U.S. could be perceived as indecisive in pursuit of its debt strategy; consultations with other creditors could be viewed as playing for time rather than dealing with the issue.

- If demar hes to other LDCs become public, other LDCs could be placed in the middle while Argentina hardens its position based upon what it views as confrontational tactics that are little more than veiled threats against Argentina.

- Risk of working at cross-purposes increases if United States and others are seen as applying a coordinated effort to "bully" Argentina into submission to the Fund and the banks. Other LDC debtors increasingly may feel compelled to choose sides in what could be viewed as a North-South confrontation.

- Could lead to a growing crisis atmosphere around time of Fund/Bank meeting.

Treasury/OASIA
August 15, 1984

SECRET

MEXICO - BACKGROUND FOR INTER-AGENCY GROUP

Overview

The Government of Mexico (GOM) remains committed to its IMF-supported economic adjustment program. Mexico's external accounts improved dramatically in 1983, reflecting further severe compression of imports and rescheduling of nearly $25 billion of external arrears and maturing debt to private and official creditors. The current account will not return to a deficit position until 1985, when economic recovery is expected to stimulate renewed demand for imports. Progress has been made in reducing inflation and the public sector deficit. A recovery is likely to materialize in 1985.

Mexico is regarded as the premier example of a successful adjuster. Reflecting this view, Mexico's leading commercial bank creditors agreed in June 1984 to negotiate a multi-year rescheduling of Mexico's debt to foreign banks. Talks are underway, but will be prolonged due to the number of complex issues to be resolved.

Status of the Economy

Mexico's trade surplus nearly doubled in 1983, reaching $14.5 billion, compared with $7.6 billion in 1982. A slight decline to $13.8 billion is expected in 1984, with a further drop, to $10.9 billion, in 1985 due to the impact of economic recovery on import demand. Mirroring these developments, the current account swung from a $5.2 billion deficit in 1982 to a $5.5 billion surplus in 1983. The surplus should drop to about $2 billion 1984; and a deficit of about $1.2 billion is expected in 1985. The peso has appreciated in real terms in 1984, due to higher than expected inflation. Although the peso is still somewhat undervalued, relative to a 1978 base, this trend appears to have stimulated some concern about the GOM's exchange rate policy and, with the added impetus of high real interest rates in the United States, given rise to increased capital flight. However, the GOM argues that the strength of the trade balance proves that the peso is appropriately valued and appears determined not to alter, at least for the remainder of 1984, its policy of depreciating the controlled and "free" rates by 13 centavos daily.

On the domestic side of the economy, progress has been made on the fiscal deficit, reducing it from nearly 18% of GDP in 1982 to 8.7% in 1983. A further reduction to 5.5-6.5% of GDP is expected in 1984, depending upon how much of its contingency fund the GOM uses in the second half of the year to stimulate economic activity. The rate of inflation is falling, dropping from over 100% in the year ending June 1983, to 81% in the year ending December 1983, and to 64.5% in the year ending July 1984. The GOM's original target of 40% for 1984 will not be met, with the rate currently expected to drop only to about 60%. Major sources of inflation have been increases in controlled prices and in the minimum wage (about 56% in 1984). The decline in real GDP appears to have been arrested, but private sector economic activity has been disappointing and the GOM is expected to increase public sector spending by an amount equivalent to 1% of GDP in the second half of the year to stimulate greater economic activity. Real GDP growth is unlikely to exceed 1% in 1984, but should be about 3.5% in 1985.

Current Situation

Talks are underway with commercial banks for a multi-year rescheduling. Conditionality and monitoring are shaping up as the major issues for the banks. The GOM rejected the banks' suggestion that Mexico obtain a series of one-year IMF stand-by arrangements after its EFF expires at end-1985, since continued quarterly performance criteria are unacceptable to it. The banks rejected the GOM's proposal of semi-annual Article IV consultations, followed by IMF certification to the banks that Mexican performance was adequate. A middle ground is not yet clearly discernable.

The GOM proposed rescheduling about $48 billion falling due in 1985-1990, including $23 billion of previously rescheduled debt, the 1983 $5 billion new money loan, and $20 billion of other debt not previously rescheduled. It proposed a 16-year tenor for the rescheduling, including 6 years grace, and deletion of the U.S. prime rate option. The GOM is forecasting a requirement for net new money from commercial banks increasing from $1.7 billion in 1985 to $3.3 billion in 1987 and 1988 and declining to $2.3 billion in 1990, resulting in a 4.4% average annual increase in the banks' exposure. Debt to official creditors is expected to increase by about 10.2% annually.

Negotiations are likely to be prolonged. Banks are approaching matters cautiously due to the expected precedent-setting effect of the Mexican arrangement. There appears to be a consensus among the banks that the ultimate objective of the rescheduling is to avoid further forced new lending, but there is no agreement on what combination of terms would produce that result. The Advisory Committee was to meet in New York for two days the week of August 6 to hammer out a tentative terms sheet and then sit down with the GOM. However, the Advisory Committee's discussions bogged down and it never did meet with the GOM. One usually reliable source reported that the committee members had agreed to accept the GOM's request for a six-year consolidation period, or "window" as the banks call it, but a Citibank representative refused to confirm this, indicating that the terms needed to be considered as a package and could not be individually accepted or rejected.

Treasury/OASIA
August 14, 1984

VENEZUELA

The GOV is trying to chart its own path through the debt crisis, steadfastly resisting creditor efforts to have it accept an IMF arrangement, and proposing a novel debt restructuring scheme. The GOV has built its case for special treatment on a base of large reserves, accumulated in part by its failure to make private sector interest payments and amassing sizeable arrears, oil exports, and some success in its economic adjustment program, which has permitted the GOV to differentiate itself from its neighbors.

Nevertheless, the GOV faces substantial medium-term risks. Its economy, which has stagnated in the last six years, is inordinately dependent on oil. If the GOV's current plan to stimulate a private sector led recovery and diversification fail, it will most likely turn to expansionary fiscal and monetary policies, leading to inflation, and/or break its pledge to reduce its foreign debt over the next several years.

State of the Economy:

Six years of economic stagnation were capped by a 4% drop in real GDP in 1983, the worst performance in 30 years. Unemployment has risen sharply, from under 6% in 1980 to 13% in 1983, as per capita income has steadily declined. Inflation has been held in check, dropping to 6% in 1983, as the GOV has applied increasingly comprehensive price controls.

The GOV is projecting a gradual reactivation of the economy beginning in 1984 with a 1% rise in real GDP. The GOV hopes the recovery will be driven by the private sector, stimulated by the depreciated bolivar and import controls, but numerous disincentives to vigorous private sector activity need to be eliminated.

Furthermore, the GOV's plan to unify and fix the exchange rate at end-1985 could halt progress made towards adjusting import and export prices if the fixed rate coincides with loosening fiscal and monetary policies in the second half of Lusinchi's five year term.

Current Situation:

On July 25, after an 18 month delay, the GOV presented its proposal for the rescheduling of public sector debt to a commercial Bank Advisory Committee (BAC). The GOV proposed that 100% of included debt (privately held bonds and debt to official creditors was excluded) totalling $22 billion be rescheduled over 16 years including 1 year grace. The interest rate would be 7/8% over LIBOR with no Prime option. The most novel aspect of the proposal was a GOV request that a "level payments" mechanism be devised, which would hold total public sector debt service payments to about $4.2 billion per year.

On August 8, the BAC presented its counterproposal, which differed significantly from the GOV proposal. In particular, the BAC proposed a repayment period of 9-10 years including 2-3 years grace; a consolidation period of 1983-85; and a spread of 1.5% over LIBOR or 1.25% over Prime. The BAC also rejected the level payments concept. The BAC stressed that, while there was a significant divergence between their opening offer and the GOV's, all issues were negotiable. Negotiations were expected to resume August 14.

Banks also feel that, having reluctantly accepted the GOV's contention that it deserves differentiated treatment (no IMF program) because it is financially stronger than other debtors, they should not be expected to turn around and provide Venezuela a very generous, and possibly concessional, rescheduling package.

Banks feel that the GOV proposal is more appropriate for a financial basket case and would impede the GOV's stated intention to return to financial markets for new (if not net new) money in the near future.

Banks report that, administrative progress notwithstanding, private sector interest arrears are at an all time high of about $1.1 billion. Banks are described as "outraged" by the GOV failure to resolve the private sector arrearage situation.

The BAC's rejection of the GOV's level payment approach to the rescheduling constitutes a serious setback to the GOV. We expect that GOV irritation over the BAC counterproposal and bank irritation over the private sector debt issue could interrupt negotiations later this summer. However, we still expect negotiations to be concluded sometime this year.

Drafted by: Treasury/OASIA
August 15, 1984